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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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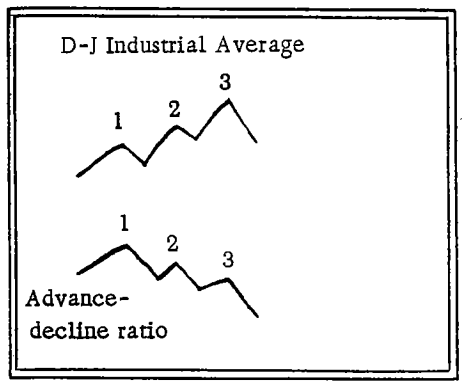
(Special Interim Report)



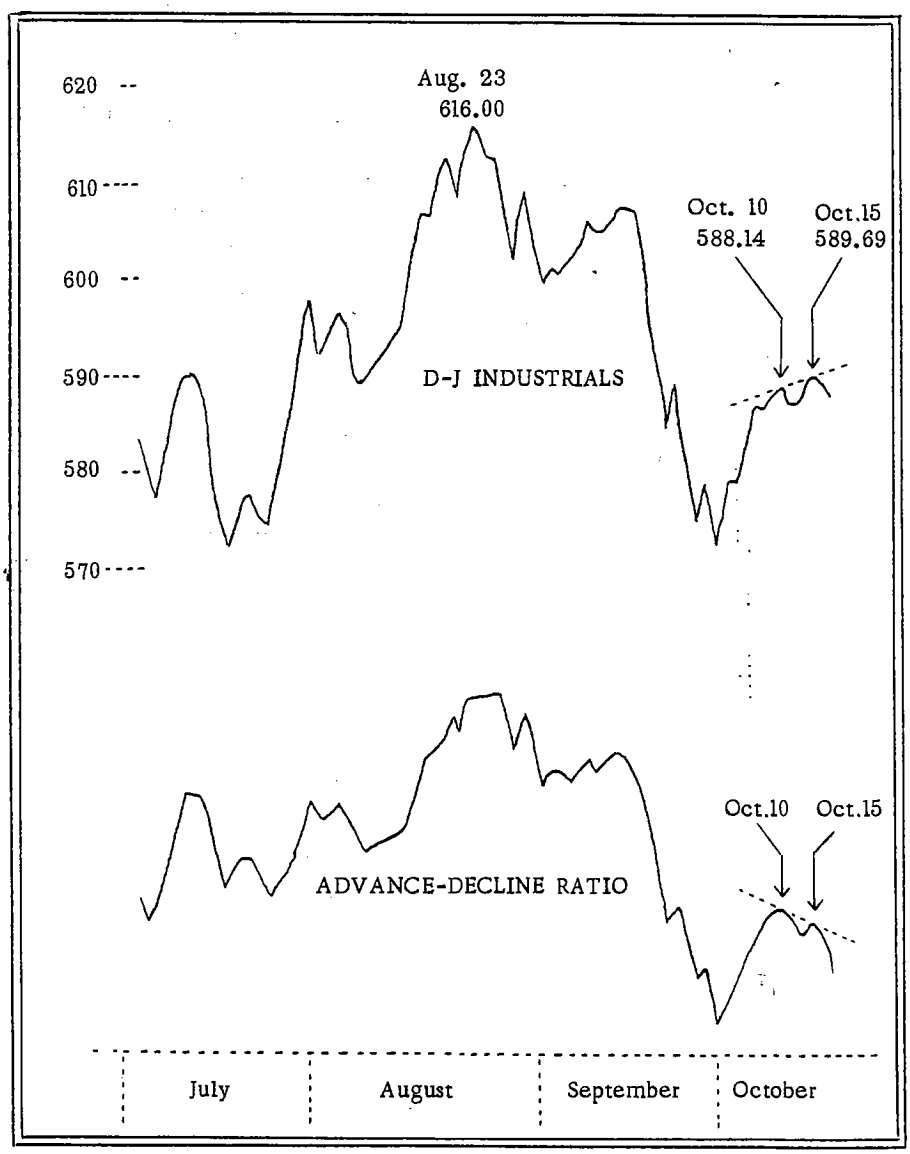
POSSIBILITY OF TRIPLE BREADTH-PRICE DIVERGENCE. The appearance of a triple divergence pattern between the Industrial Average and the advance-decline ratio has been one of the most reliable "major sell signals" in market history. Letter 170 (February 8, 1962) presented a detailed discussion of the divergence which was developing between Industrials and the A-D ratio at that time. For those who do not have that Letter, I have included (at right) a chart showing the classic danger signal or triple-divergence between breadth and price.

At point 1 on the smaller chart both the Industrial Average and the A-D ratio establish joint peaks. A decline follows, and on the next rally Industrials rise to a second recovery high (at 2) but the A-D ratio remains below point 1. Another decline takes place, followed by a rally. On this rally Industrials establish a third recovery high (at 3), but again the A-D ratio fails to confirm. At this juncture we have a triple-divergence.

Following point 3, if the two indicators turn down on increasing volume we have a major sell signal. Some of the most drastic declines in market annals have followed this type of formation.

On October 10, 1962, (see larger chart) the Industrials and the A-D ratio rallied to joint peaks (Industrials 588.14). A two-day decline followed, after which Industrials rallied to a new minor recovery high (October 15, at 589.69). Note the A-D ratio's failure to confirm. Another decline followed, and October 17 found Industrials a few points under their October 15 (589.69) peak, but note that the A-D ratio had dropped (in a downward zig-zag) far below its peak.

If another rally now succeeds in taking Industrials to a (third) recovery close above the October 15 close of 589.69, there is slim chance that the A-D ratio will be able to confirm (it is too far below its October 10 peak). Therefore, if Industrials rally above 589.69 and then turn down, I would take such action to be a major selling and short selling signal. The technical



"vacuum" created by a triple divergence between price and breadth has given way to some of the worst declines (and most profitable shorting areas) to be found in the history of the price-breadth relationship.

QUESTION Suppose the Industrial Average and the A-D ratio simply continue to drop, thereby eliminating the possibility of a triple divergence? ANSWER We will then have to watch the 571.24 Industrial level (see last Letter). If 571.24 is penetrated on increasing volume the market will be in position to "test" the bear market lows.

QUESTION Suppose after a further slight decline, both the A-D ratio and Industrials push above their respective October 10 and 15 peaks? ANSWER Such resolutions are extremely rare in this type of situation. If this does occur and volume increases on the upside the Industrials would have to clear the August 23 peak of 616.00 before I would be impressed.

"BEAR MARKETS," wrote Robert Rhea, "seem to be divided into three phases: the first being the abandonment of hopes upon which the final uprush of the preceding bull market was predicated; the second, the reflection of decreased earning power and reduction of dividends, and the third representing distress liquidation of securities which must be sold to meet living expenses. Each of these phases seems to be divided by a secondary reaction which is often erroniously assumed to be the beginning of a bull market."

Referring to the present situation, it seems to me that we are now about at the end of the first phase of the bear market and entering the second. The actual transition is not clear or precise -- it never is.

Nevertheless, the business news is beginning to turn sour, dividends are being cut, a few large bankruptcies have marred the recent scene, price cutting is rampant, unprofitable corporate products and divisions are being amputated, and profit margins are continuing to be squeezed. Thus the seams of the great boom are beginning to come apart. The second phase of a bear market is the phase in which the champagne evaporates and the "dirty water" becomes painfully obvious.

Another phenomenon which is worth discussing is the current reaction of individual stocks to news (expected or otherwise). Thus on the news of a dividend cut Wheeling Steel dropped below 30 (its 1957 low) to its lowest level in over a decade. On the same news Republic Steel dropped to its 1954 levels. Last week Tennessee Gas Transmission lowered the dividend and the stock fell (on heavy, panic selling) below its entire 1959-62 range back to the levels of early 1958. Each of these precipitous declines came following earlier major declines, suggesting that despite vastly lower prices, those stocks had not fully discounted bad news.

Thus for the first time in a generation we are witnessing the spectacle of individual stocks collapsing on the actual release of bad news. Such action is typical of the second phase of a bear market. In comparison, many subscribers may remember the bull market) action of stocks in 1958 when those stocks were confronted with bad news. In most cases, dividend cuts or poor earning statements were greeted with impressive "holding action" or even rallies. In 1958 (in typical bull market style) informed investors bought stocks on the release of the bad news.

LATE NOTES (Written Thursday, Oct. 18, 1 P.M., N.Y. time). As this is written Industrials are down over 4 points on decreasing volume. Rumors are rampant to the effect that the total short position will be up 15 to 20% this month. Such rumors would be enough to send a bull market sharply higher. Yet such is not the case today.

STOCKS The mass of stocks on the New York Stock Exchange continue to perform worse than the "blue-chip" Industrial Average. On the June-August, 1962 recovery, the Industrial Average retraced 43% of its March-June losses while the A-D ratio regained only 34% of its own losses. Then on the August-September decline (see large chart on page 1) Industrials erased 53% of the June-August gains while the A-D ratio lost 73% of its June-August gains. On the most recent recovery from the September lows, the A-D ratio has diverged with Industrials and seems not to want to rally at all. In other words, the A-D ratio (representative of the advancing and declining tendencies of all the stocks on the Board) has consistently lagged behind the Industrial Average on advances and declined further than the Industrial Average on declines. This action must be considered bearish.

The weakest stock groups at this time are Cements, Communications, Steels, Rubbers, Rails and Tobaccos. Preceding Letters have listed stocks which I felt were good short candidates. The following stocks look weak and may be shorted on market weakness, particularly if it materializes as per page 1: Amer. Tel., Western Union, Lone Star Cement, Penn Dixie Cement, Firestone and Goodrich Rubber, Bethlehem and U.S. Steel, Amer. Tobacco, Lorillard, Phillip Morris.

The monthly chart of Bethlehem Steel shows an almost unbelievable "head-and shoulders" top extending over many years. The latest drop below 32 took BS below its 1957 low and completed the top. The market has said that BS is in for bad news ahead (chart from M.C. Horsey, 37 Wall Street, New York City)